

UNITED STATES OF AMERICA

October Term, 1907

No. 700 and 701

Commissioners of Internal Revenue

Respondents

vs.

No. 700

Living George and Margaret Good

Plaintiffs

On Writ of Habeas Corpus issued from Court of Appeals
for the Second Circuit

Charles E. Hall and Percy C. Hall

Respondents

No. 701

Commissioners of Internal Revenue

Respondents

On Writ of Habeas Corpus issued from Court of Appeals
for the Second Circuit

THE UNITED STATES OF AMERICA

vs.

CHARLES E. HALL AND PERCY C. HALL

Plaintiffs

Commissioners of Internal Revenue

Respondents

On Writ of Habeas Corpus issued from Court of Appeals

for the Second Circuit

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1967

Nos. 760 and 781

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

IRVING GORDON and MARGARET GORDON,

Respondents.

No. 760

**On Writ of Certiorari to the United States Court of Appeals
for the Second Circuit**

OSCAR E. BAAN and EVELYN K. BAAN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No. 781

**On Writ of Certiorari to the United States Court of Appeals
for the Ninth Circuit**

**REPLY BRIEF OF RESPONDENTS IN NO. 760
AND OF PETITIONERS IN NO. 781.**

This brief is filed on behalf of the respondents in No. 760 and the petitioners in No. 781 ("taxpayers"), in reply to the brief filed February 29, 1968, for the peti-

tioner in No. 760 and for the respondent in No. 781 ("Commissioner").¹

QUESTIONS PRESENTED

The principal question presented by these cases relates to the application of section 355. The Commissioner has not framed the question in his brief, however, so as to reflect properly the opposing views of the parties and to apprise the Court of the real issues in these cases. There is *no issue*, as suggested by the Commissioner, whether the distribution of *rights* qualified for nonrecognition of gain under section 355 (Com. Br. 2, 15). Such a contention has never been made on behalf of taxpayers, nor has any of the courts below so held. The Commissioner's statement of the question is lacking also (Com. Br. 2, 16) in that it ignores a question which *was* presented and decided in the three courts below, whether the distribution of *all* the Northwest stock by two rights offerings under a single plan of divisive reorganization qualifies for nonrecognition under section 355.

The Commissioner determined the deficiencies involved in these cases in accordance with his rulings of June 28, 1961, and November 15, 1962 (A. 152-153, 158-159).² The Commissioner determined that the receipt of the Northwest stock, not the receipt of the *rights*, was taxable in-

¹References to the Commissioner's brief will appear hereinafter as "Com. Br." References to the taxpayers' opening brief will appear hereinafter as "Taxp. Br."

²The pertinent rulings are quoted and briefly analyzed in taxpayers' opening brief, page 56, footnote.

come upon the exercise of the rights by the taxpayers, measured by the difference between the value of the Northwest stock at the date of exercise and the offering price. Strangely, nowhere in his brief before this Court has the Commissioner seen fit to contend that his original determination was correct. He now contends that the subject of the distributions which are taxable is the Northwest rights. Nowhere does he advise the Court *how*, under his new theory, these rights should be taxed where they are exercised. The Commissioner ~~limits his discussion of the manner of taxing rights under his theory to the situation where rights are sold.~~ He states that:

"Analytically, the rights should be considered dividend income on the date distributed. * * *

"Although this is the technical analysis of the situation, it is convenient in these cases, where rights are sold, to minimize the amount of computation involved, and to treat the proceeds on sale as being the dividend, rather than the fair market value on the date of the receipt of the rights" (Com. Br. 49).

While espousing this novel rule of "convenience" where rights are sold, the Commissioner fails to deal with other essential questions involved in the tax treatment of stock rights which are inherent in and flow from his underlying theory.

How does the "convenience" rule apply where rights are exercised? Where rights have a market value, does "taxability of such rights depend on whether there is a so-called "spread" between the offering price and the value of the stock at the time the rights are issued? Where rights are exercised, is the amount of income the value of the rights at the time of receipt; the value of the rights

at the time of exercise; or the "spread" at the date of exercise? Where rights lapse, is income received at the time the rights are issued, and a loss sustained when the rights lapse? In the case of corporate shareholders receiving and exercising rights, are such rights *not* dividend income on the ground that the rights had no basis in the hands of the issuing corporation?

The Commissioner's improper statement of the issue raises questions on the tax treatment of rights which he signally fails even to mention.

THE COMMISSIONER'S STATEMENTS OF FACT

The Commissioner's brief is so replete with inaccurate statements of fact, misrepresentations of the record and misleading and improper inferences and speculations not supported by the record as to present a seriously distorted picture of the actual facts. The facts of these cases are the facts found by the Tax Court. They are properly summarized in the statement of the case set forth in the taxpayers' brief (Taxp. Br. 4-23). The Commissioner took no exception to the findings of fact by the Tax Court during the course of these proceedings.

Prominent among these distortions are the Commissioner's statements that Pacific chose not to distribute the Northwest stock directly to the Pacific shareholders without consideration "for its own reasons," and "[i]t did not suit Pacific's purposes to distribute the stock to its own shareholders without consideration, for it wanted to use the stock as a means of raising the funds to pay off

the advances from A. T. & T. and to raise additional capital for use in its California operations" (Com. Br. 38). Similar statements are made suggesting that Pacific could have chosen to distribute the Northwest stock without consideration but instead chose to use stock rights offerings in order to raise capital (Com. Br. 4, 6, 37). The record is clear that the reason why Pacific decided to use rights offerings and require a cash consideration was that Pacific had been advised by its counsel that it could *not* lawfully, under the California corporation law,³ distribute the stock directly to Pacific's shareholders without payment of consideration by them. After such method was discarded as the means of distributing the Northwest stock to its stockholders, Pacific turned to rights offerings and, since this method involved the inflow of capital, adapted the method of distribution to its capital requirements.⁴ To suggest that Pacific adopted the rights-offering method for the direct purpose of raising capital, rather than for its real and primary purpose of the distribution of the Northwest stock in conformity with the California corporation law, is false.

³Mr. Einerman, the Vice President and Comptroller of Pacific, testified (A. 199):

"A. Mr. Holt, as I stated, we considered many plans, and the plan that you mention of distributing the shares in the form of a stock dividend was one of the plans that was considered, and we had to eliminate that one immediately, because we were advised by counsel that it was illegal to do this.

"Therefore we didn't pay any more attention to that particular plan. We went ahead to develop a plan that we could use."

⁴Normally, Pacific's method of raising new capital was the issuance of Pacific's own stock and debentures (A. 47). These methods, of course, were still available to meet its needs for capital in 1961.

After erroneously stating that Pacific could have distributed the Northwest stock to the Pacific shareholders without consideration, as noted above, the Commissioner makes another misleading statement: "Pacific could also have sold the Northwest stock at market value, a course it recognized as 'the normal tendency' (R. 91), in which case its shareholders would have received no gain in the transaction" (Com. Br. 38). The record is devoid of any evidence that Pacific could have carried out its plan of distributing the Northwest stock to its shareholders by offering the Northwest stock to them "at market value." The fact is that the offering price was fixed at approximately 40 per cent below market value in order to induce the Pacific shareholders to exercise their rights and achieve as wide a distribution of its stock to its shareholders as possible.⁵

In similar vein is the Commissioner's statement at pages 3 to 4 that a distinct objective which Pacific "wished to satisfy through such a division [of Pacific's business]" was to generate enough cash to liquidate a substantial portion of Pacific's accumulated indebtedness to American. On the contrary, the decision to divide Pacific into two separate corporations with separate stock ownership had nothing to do with the liquidation of American's advances.⁶ That decision was based on studies

⁵In presenting the plan of reorganization to the Pacific directors, Mr. Einerman stated:

"A lower price would produce higher rights values and should result in a broader distribution of the stock among our shareholders" (A. 91).

⁶The stipulation shows clearly that obtaining advances from American was the normal method of temporary financing used by Pacific. Permanent security financing was substituted when these advances had grown large enough to warrant it (A. 37).

conducted over a period of more than two years, which concluded that the division would be extremely desirable from an operating point of view (A. 235-236). The operating and management advantages sought to be achieved by the separation are set out in the Tax Court's findings. Any implication that the satisfaction of the indebtedness to American was a motivating factor of the divisive reorganization is untrue.⁷

The Commissioner makes a serious misrepresentation of Pacific's commitment to offer *all* of the Northwest stock to its shareholders under the plan. The Commissioner states, "Pacific thus was under no obligation to offer the remainder of the Northwest stock at any point in time" (Com. Br. 40-41). At page 13 and again at page 16, the Commissioner does not even bother to qualify the statement by reference to a point in time; he says (p. 16), "where the remaining 43 percent was disposed of * * * in

⁷The statement (Com. Br. 38) that, but for the filing of a consolidated return, American might have realized a taxable gain of \$150,000,000 from the exercise of the Northwest rights, is false and misleading. Apparently it is designed to suggest a callous disregard on the part of Pacific of the tax position of its shareholders other than American. The fact is that American's tax position had nothing to do with the consolidated return. Under the Commissioner's own rulings, not applying section 355, the amount of any distribution by Pacific to American and *all other corporate shareholders* of Pacific, was the excess of the basis of the Northwest stock in the hands of Pacific over the offering price (sec. 301(b)(1)(B)). Since the basis of such stock was less than \$16 a share, neither American nor any other corporate shareholders of Pacific was deemed to have received a dividend (A. 123). This was the result whether or not American filed a consolidated return.

Equally misleading is the Commissioner's mention of Pacific's receipt of an unfavorable ruling with respect to the individual shareholders (Com. Br. 8, 38), and his failure to mention that Pacific had immediately sought reconsideration of this ruling, which was not forthcoming until November 15, 1962 (A. 71, 155).

a transaction which *was in no way obligated* at the time the first offering was made. Can an offering of 57 percent of stock, *with no further obligation*, constitute disposition of 'control' * * * (emphasis added).

The facts are that the plan provided:

"The Pacific Company *shall* offer to its shareholders as set forth below the right to purchase *all* of the shares of capital stock of the New Company acquired pursuant to this Plan" (emphasis added; A. 238).

The plan provided that after the first offering in 1961 (A. 103-104):

"At a time or times related to its need for new capital, the Company *will* offer the remainder of the shares of the New Company for sale in a similar manner to shareholders of the Company" (emphasis added).

The prospectus accompanying the first rights offering stated "the balance of the 30,460,000 shares * * * *will* be offered for sale later" (A. 117—emphasis added); and "later" was defined as "*within* about three years * * * at times related to its need for new capital" (A. 125—emphasis added).⁸ The registration and proxy statements containing these commitments were filed with the Securities and Exchange Commission, thereby exposing Pacific

⁸By avoiding mention of these statements from the plan and prospectus and pointing instead to a single selected statement out of the entire context: "It is expected that within about three years after acquiring the stock of the New Company, the Company by one or more offerings will offer for sale the balance of such stock, * * *" (A. 109), the Commissioner misrepresents Pacific's commitment. The words "it is expected" obviously referred to the maximum period within which the distribution would be completed, rather than to any indefiniteness of the obligation itself.

to civil and criminal liabilities if any material misrepresentations were made.

There was virtual assurance that Pacific's demands for new capital would require that the remainder of the Northwest stock be offered within three years. Pacific's capital needs could be predicted with a high degree of certainty.⁹ In point of fact, all of the Northwest stock was distributed by Pacific within less than two years after the first offering (A. 61-62).

Another serious distortion occurs in the Commissioner's explanation of the \$16 offering price for the Northwest stock. The Commissioner explains the offering price almost entirely on the basis of providing shareholders with rights offerings that they would consider additional dividends (Com. Br. 7, 38). The findings conclusively establish that the offering price was based on a consideration of seven different factors, each given equal weight, three affecting Pacific, and four affecting the Pacific shareholders (A. 249-250). Mr. Einerman, who presented the plan to the Pacific board of directors, stated that there was no intention to recommend that a dividend be distributed through the rights offerings (A. 190). The whole tenor of the Commissioner's presentation is that the Northwest

⁹Pacific's rate of growth, which was expected to continue, is illustrated by the fact that the operations of Pacific in California alone in 1960, in terms of plant investment and operating revenues, exceeded those of the entire company in California, Oregon, Washington and Idaho in 1957 (A. 46). In the seven 12-month periods prior to June 30, 1960, Pacific, by the issuance of common stock or long-term debentures (A. 240), had raised new capital totaling \$1,313,000,000 and averaging approximately \$187,000,000 per year; for the last five of those years, the average was \$225,000,000 (A. 85).

stock was simply an asset which was disposed of by Pacific as "part of an elaborate refinancing operation" (Com. Br. 21; 38-39). On the contrary, Pacific's plan was conceived and carried out as a divisive reorganization,¹⁰ and basic to the plan was the distribution of the Northwest stock to Pacific shareholders. A price was established reflecting all seven factors, which would result in as wide a distribution of the stock as possible among the Pacific shareholders (A. 91). The success of the offerings may best be gauged by the fact that more than 95 per cent of the rights issued to the Pacific shareholders were exercised by them (A. 62, 141).

I

THE COMMISSIONER'S POSITION IN GENERAL

The Commissioner's arguments are predicated on isolating the steps in carrying out Pacific's plan of reorganization and persistently refusing to regard these steps as integral parts of a single, unified plan of reorganization.

¹⁰Mr. Einerman testified on cross examination as follows (A. 225-226):

"Q. Wouldn't you conclude, though, that since Pacific, as far as the offering of the Northwest stock through rights was concerned, was merely selling some of its assets at a profit or a figure over book, and so long as the fair market value of the assets they were selling was received by the corporation, then no distribution of any property took place to the common stockholder and the preferred could not legitimately have any complaint?

"A. Well, I can't agree with that because, as I mentioned this morning, basically, this entire transaction was part of a plan of reorganization. We were not selling an asset of the company just as such. The whole transaction was geared to this plan of reorganization."

With equal persistence he attributes to the plan a primary motive of raising capital, and disregards its true genesis and objective of effecting a divisive reorganization of Pacific's business. The evidence and the Tax Court's findings are clearly contrary to his position.

The Tax Court found: "As a result of the studies [looking toward the division of Pacific into two or three separate companies] Pacific was divided into two separate divisions in 1960 and was then divided into two separate corporations in 1961. * * * The reasons given for dividing the operations of Pacific were the size of the area served by the company * * * the rapid growth of the population * * * and the expected continued growth of the population of the area with a continuing increase in the amount of telephone service required" (A. 236). The Tax Court concluded, "This case concededly involves a spin-off. Pacific plainly divested itself of the business which it had conducted in the three northwest states" (A. 262). There can be no doubt on this record that what Pacific planned and what it in fact accomplished pursuant to the plan was the division of Pacific's business into two corporate entities, each for practical purposes being owned by the same shareholders.

In focusing upon single steps viewed out of the context of the plan as a whole, the Commissioner disregards not only the findings of the Tax Court, but the terms of the plan itself, the proved intention with which it was conceived and carried out, the result which it achieved, and the exposure to penalties had Pacific not carried it out as represented to its shareholders.

As the Second Circuit recognized, where it has served his purpose the Commissioner has not hesitated to argue that separate steps should be disregarded and a reorganization recognized for tax purposes (*Moffatt v. C.I.R.* (9 Cir. 1966) 363 F.2d 262, certiorari denied (1967) 386 U.S. 1016). This has been on the principle that the substance of transactions controls the tax result.

Throughout his brief, the Commissioner has based arguments on the assumption that the 1961 and 1963 offerings of Northwest stock should be separately viewed and treated. This is directly contrary to the finding of the Tax Court that these two stock offerings were component parts of a single plan and must be regarded together as resulting in the distribution of 100 per cent of the Northwest stock in a single transaction (A. 255, n. 4). The Commissioner's view of the stock rights apart from the distribution of the stock and the consummation of the plan of reorganization is equally unsupported. That the rights were the necessary mechanism to effect the distribution of the Northwest stock to the Pacific shareholders is thoroughly established by the record.

In thus dismembering Pacific's integrated reorganization plan, the Commissioner violates a cardinal rule of interpretation and tax treatment of plans of reorganization. This is the rule pronounced by this Court in *Helvering v. Alabama Asphaltic Limestone Co.* (1942) 315 U.S. 179, 184-185:

"Yet, the separate steps were integrated parts of a single scheme. Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts where they add nothing of substance

to the completed affair. *Gregory v. Helvering*, 293 U.S. 465; *Helvering v. Bashford*, 302 U.S. 454. Here they were no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan."

Not only has the Commissioner distorted the purpose and intent of the plan, but he has failed to supply any credible, rational basis for imputing income to taxpayers by reason of the exercise of their rights. When taxpayers exercised their rights, they owned no more than they had owned before, as shareholders of Pacific alone. Instead of having only certificates evidencing their ownership of an equity in Pacific, they had two pieces of paper evidencing their same proportionate ownership of an equity in Northwest and Pacific. And far from receiving any benefit which might be characterized as income, they were out-of-pocket, having paid cash into Pacific.

Both the Tax Court and the Second Circuit found it inconceivable that Congress could have intended that no tax should result if the Northwest stock had been distributed to taxpayers without consideration, but that a tax should result, as contended by the Commissioner, when they had paid out money (A. 262, 285). Nowhere does the Commissioner's brief attempt to explain, justify or supply any rational basis for imputing such an intent to Congress. The Commissioner does not in his brief provide any logical or common-sense answer to the question so properly asked by the Second Circuit (A. 277): "how this corporate change of asset ownership brought income to them and, if so, where is it?"

II

THE COMMISSIONER IS IN ERROR IN CONTENDING THAT THE DISTRIBUTION OF THE NORTHWEST STOCK WAS NOT PART OF A BONA FIDE SPIN-OFF WHICH FULFILLED THE CONGRESSIONAL PURPOSES OF SECTION 355.

As our opening brief demonstrates (Taxp.Br. 29-51), Pacific's plan of reorganization achieved the results and fulfilled the Congressional purposes contemplated by section 355.

These purposes are conceded by the Commissioner (Com.Br. 18-20) in words that strikingly fit the transaction at bar:

"The Senate Finance Committee, in recommending the legislation, commented, '[I]t is economically unsound to impede spin-offs which break-up businesses into a greater number of enterprises, when undertaken for legitimate business purposes.' * * *

* * * * *

"That [legislative] objective was to facilitate the breaking down of the size of corporate undertakings, * * *. The spin-off which Congress had in mind, and to which the language of the statute is clearly directed, is the breaking up of a business into two or more separate entities, with the consequence that the size of the original corporate enterprise is contracted by the genuine separation of its businesses into distinct entities. The shareholders continue to own both, having now more pieces of paper to represent their aggregate ownership than they had before."

This was exactly what was accomplished here. The business formerly conducted by a single corporation—Pacific—in the four states, was broken up into two cor-

porations, with Pacific continuing the business in California, and Northwest continuing the business in the three northwest states. There was a genuine separation of the businesses into the two distinct corporations. There were clearly legitimate business purposes, as the Commissioner concedes (Com.Br. 20). Pacific's original enterprise was contracted to the California operation, while the business in the three northwest states went entirely to Northwest. Pacific's shareholders for all practical purposes continued to own both corporations.

The Commissioner's argument that the transaction at bar falls outside the basic objective of section 355, in simple terms comes down to two points (Com.Br. 20-21):

(1) That there was no spin-off, no breakup of a business, no contraction of the business, all because the business in question was that of American, so that the transaction was a mere rearrangement of American's business rather than a reorganization of Pacific. On the contrary, the stipulations and findings of fact (A. 35, 38, 229, 231) establish beyond question that the business divided and reorganized was that of Pacific¹¹ before the reorganization, and that of Pacific and Northwest separately after the reorganization. Nothing in either the words or the legislative history of section 355 even remotely supports the Commissioner's conjecture that Congress "perhaps" might have denied tax-free treatment in case of a spin-off of a subsidiary of a subsidiary to the ultimate parent (cf. Rev.Rul. 62-138, C.B. 1962-2, 95);

¹¹The Commissioner's brief (pp. 3, 4, and 7) also contains positive assertions that the business was that of Pacific.

and the Commissioner admits that Congress did not do so (Com.Br. 20).

(2) That there was no contraction of the Pacific business enterprise because Pacific used the proceeds arising in connection with the distribution of the Northwest shares to refinance past borrowings and finance further expansion. To argue that Pacific's business was not "contracted" when its operations shrank from four states to one state simply denies the obvious. In passing, it should be noted that section 355 is not cast in terms of "contraction" of a business enterprise. As its legislative history plainly reveals, section 355 deals with the *division* of business enterprises, and the continuation of such businesses under two or more corporations instead of only one.¹²

The Commissioner's attempts to draw an analogy between these cases and the tax-avoidance case of *Gregory v. Helvering* (1935) 293 U.S. 465 (Com.Br. 21-22), are wholly unwarranted. The attempted reorganization in *Gregory* was a masquerade, a mere artifice entirely lacking in business purpose and designed solely for tax avoidance. The *Gregory* case does not even remotely resemble the situation here, involving a bona fide divisive reorganization with no possible element of tax avoidance, which the Commissioner concedes (Com.Br. 20) was adopted for legitimate corporate business purposes.

¹²Section 355(b)(1)(A) expressly requires continuation of the active conduct of the business by all participating entities. Treasury regulations further emphasize this requirement:

"Section 355 contemplates a continuity of the entire business enterprise under modified corporate forms * * *" (Income Tax Regs. sec. 1.355-2(c)).

As the legislative history shows, subject to restrictions on distribution of earnings and profits none of which are applicable here, Congress intended in section 355 to dispense with mechanical requirements and liberalize the law in cases involving mere rearrangements of the corporate structure.¹³ Pacific's plan clearly carries out the purposes of Congress under section 355.

III

THERE IS NO MERIT IN ANY OF THE COMMISSIONER'S CONTENTIONS DIRECTED AT THE CONSTRUCTION OF SECTION 355.

- A. The Commissioner is in error in contending that Pacific did not distribute "solely stock or securities" of Northwest as required by section 355(a)(1)(A).**

The Commissioner's elaborate argument (Com. Br. 23-25) that the rights did not satisfy the "solely stock or securities" requirement since they were not stock or securities, may be dismissed as not relevant to the issues raised in these cases. There is no contention that the Northwest rights were either stock or securities, and none of the courts below so held.

In contending that the receipt of the rights constituted dividend income, the Commissioner first attempts to dis-

¹³The Commissioner's cursory treatment of the changes in the divisive reorganization provisions effected by section 355 (Com. Br. 18-19) is neither complete nor accurate. The Commissioner merely states that section 355 carried forward the requirements of the 1951 Act and added several specific and detailed new requirements, substantially narrowing the class of transactions qualifying for nonrecognition (Com.Br. 19). A proper analysis of the legislative history of section 355, enumerating the many liberalizing features, is set forth in the taxpayers' brief (pp. 31-36).

tinguish *Palmer v. Commissioner* (1937) 302 U.S. 63, and then argues that in any event the *Palmer* rule no longer applies under the 1954 Code (Com. Br. 26-28, 46-47). The Commissioner rejects the widely held view that *Palmer* decided that the receipt of rights to buy portfolio shares¹⁴ did not constitute income. He contends that *Palmer* merely decided the date to be used in determining whether the issuance of the rights resulted in income, i.e., the date of issue or the date of exercise, and that the Court's statement in *Palmer* that the mere issue of rights is not a dividend must be read in the light of the absence of a spread in *Palmer* at the time the rights were issued.

The Commissioner is in error in denying that the *Palmer* case decided the issuance of rights is not a taxable event and does not result in taxable income. This Court's review of the *Palmer* case resulted from a conflict among five courts of appeals as to whether receipt of rights resulted in taxable income or whether the exercise of rights was the taxable event. The *Palmer* case dealt with the nature of stock rights and the tax effect of their issuance and exercise. As *Choate v. Commissioner of Internal Revenue* (2 Cir. 1942) 129 F.2d 684 and other cases following *Palmer* have held, the *Palmer* case decided that the mere issuance of rights is not a

¹⁴The Commissioner refers to portfolio shares as the stock one corporation owns in another, but his use of this term with reference to the Northwest stock is misleading in that he suggests that the Northwest stock was an investment of Pacific. Northwest was created by Pacific immediately prior to the first rights offering for the express purpose, under Pacific's plan, of providing the corporate vehicle to receive the divided business and assets in the three northwest states, so that the stock of Northwest could be distributed to the Pacific shareholders.

dividend because thereby there is no distribution of corporate assets or diminution of the net worth of the corporation in any practical sense. The rights are mere offers and are not closed and completed transactions until either accepted by exercise or sold. No distribution of corporate property takes place until the rights are exercised.

This rule as to the time of distribution in the case of stock rights is in keeping with the general rules governing distributions of cash dividends. A distribution of a cash dividend does not take place on the declaration date or the record date, but rather on the date the dividend is payable. This rule applies whether the shareholder is on a cash basis or an accrual basis. (*Avery v. Commissioner* (1934) 292 U.S. 210; *Estate of Putnam v. Comm'r* (1945) 324 U.S. 393). Despite the fact that the right to a dividend declared may be property to the shareholder, and even subject to separate transfer when the stock is selling ex-dividend, there is no distribution, i.e., no dividend, until the dividend is paid. The reason for this rule was explained in *Commissioner of Internal Rev. v. American L. & T. Co.* (7 Cir. 1946) 156 F.2d 398. A dividend must be a distribution out of earnings and profits, and the sufficiency of earnings and profits for a dividend is determined as of the date of payment and not as of the date of declaration (*Mason v. Routzahn* (1927) 275 U.S. 175).

Here there was a "spread" at the time the Northwest rights were issued, but the distribution did not occur until the rights were exercised. At that time the property distributed was the Northwest stock itself—not the rights, since the rights were extinguished upon exercise. The

Tax Court properly held that under the *Palmer* case the subject of the distribution, i.e., the corporate property transferred, was not the rights but the Northwest stock.

The Commissioner asserts that the *Palmer* rule no longer applies because of certain changes in the 1954 Code. He argues that such changes support his contention that "a distribution of transferrable [sic] rights to acquire corporate property at less than fair market value is taxable" (Com. Br. 28).¹⁵ This argument is further elaborated in the discussion in the Commissioner's brief, pages 47 to 49 inclusive.

The Commissioner's principal reliance is on the definition of property in section 317 for purposes of dividend distributions under section 301. Property is defined as not including "stock in a corporation making the distribution (or rights to acquire such stock)." The Commissioner argues that therefore the term "property" as used in section 301 includes rights to subscribe to shares of stock of another corporation, and that the Northwest rights were property taxable at their fair market value when received (Com. Br. 28, 48). He concludes that the *Palmer* rule no longer obtains under the 1954 Code, and that rights to subscribe to "portfolio shares" are taxable distributions of corporate property as of the date issued, at their fair market value on such date. Contrary to his

¹⁵It may be more proper to refer to the "issuance" of rights when rights are created, rather than "distribution" of rights, so as to take cognizance of the distinction noted in *Palmer* that the "distribution" of corporate property occurs when the rights are exercised and that there is no such "distribution" at the time the rights are issued. There may be situations where rights received by a corporation may in turn be the subject of a distribution to its shareholders (CCH Capital Changes Reporter, Explanatory Guide, par. 208.04).

novel argument, no court which has passed on the tax treatment of stock rights under the 1954 Code, including the three courts below, has considered that the Code made any change in the *Palmer* rule (e.g., *William H. Bateman* (1963) 40 T.C. 408).

The Commissioner's reliance on the definition of property in section 317(a) is misplaced.¹⁶ The ruling in *Palmer* that the receipt of stock rights is not income did not turn on the question whether stock rights in the hands of the recipient shareholders were property. It was assumed in the *Palmer* case that they were, since even at the date of issuance the rights were valuable. In the *Palmer* case, as here, the Commissioner contended that stock rights were taxable when received on the ground that they constituted "property" for dividend purposes. The definition of a dividend in section 115(a)¹⁷ of the 1928 Act, dealt with in *Palmer*, was just as broad as the definition of a dividend in present section 301. Nonetheless, the Court held that the rights were not dividends.

The absence of a dividend on the mere issuance of rights under *Palmer* is predicated on the nature of stock

¹⁶The exception clause in section 317 may readily be explained by reference to section 305(b). Under section 305(b), Congress carried over and supplemented a provision of prior law for the taxation of stock or stock rights in the same corporation if paid "in lieu of" money. The new definition of property in section 317 made desirable the clarification that while "in lieu" stock or stock rights were taxable property for purposes of section 301, stock of the distributing corporation and stock rights in such corporation were not property for such purposes, as held in *Eisner v. Macomber* (1920) 252 U.S. 189, and *Miles v. Safe Deposit Co.* (1922) 259 U.S. 247.

¹⁷(a) *Definition of dividend.*—The term 'dividend' when used in this title * * * means *any distribution* made by a corporation to its shareholders, whether in money or in *other property*, out of its earnings or profits * * * (emphasis added).

rights. The cases at bar present an even stronger situation than did *Palmer* for not treating the rights as a taxable distribution. In *Palmer*, the stock to which the rights related was a "portfolio" investment. Here, Northwest was created by Pacific, and all of its stock was held by Pacific temporarily, until the division and spin-off of Pacific could be completed. The short-term rights were part of the corporate mechanisms employed. The situation resembles *Miles v. Safe Deposit Co.* (1922) 259 U.S. 247, where stock rights to acquire more stock in the same enterprise were held to be no division of corporate profits or capital, but an opportunity for the shareholders to participate, in preference to strangers, in contributing additional capital to the enterprise (259 U.S. 251-252).

The 1954 Code made no change in the language of section 301 requiring a "distribution of property." The Committee Reports covering Subchapter C of the 1954 Code, dealing with corporate distributions, are devoid of any evidence that Congress intended to change the rule of the *Palmer* case and to make stock rights taxable on receipt rather than exercise. On the contrary, the House and Senate Committee Reports state that section 301 was "derived generally from," or "represented a restatement of existing law under," section 115(a), (b), (d), (e) and (j) (H.Rept. 1337, 83d Cong., 2d Sess., p. A70; S.Rept. 1622, 83d Cong., 2d Sess., p. 231).

Nothing in *Commissioner v. LoBue* (1956) 351 U.S. 243, or *Commissioner v. Smith* (1945) 324 U.S. 177, is at odds with the *Palmer* case. Those cases did not involve any question of the distribution of a dividend to a stockholder as in *Palmer*. The issue in *LoBue* and *Smith* related to

the determination of income under section 22(a) of the Internal Revenue Code of 1939 from stock options received by employees as compensation for services. The cases dealt with whether the amount of such income was measured by the spread at the date of exercise or the date of receipt. Both of these cases cited *Palmer* with approval. The contention by the Commissioner (Com. Br. 27) that employee stock options having a readily ascertainable value were treated as property in the *Smith* and *LoBue* cases does not run counter to the *Palmer* case. Like the change in the 1954 Code on the definition of property, these cases do not reach the question considered and disposed of in *Palmer* whether the issuance of stock rights was a distribution of corporate property constituting a dividend.

The tax results of the Commissioner's theory, which are not fully developed by the Commissioner, provide an excellent reason why Congress was well advised in the overhaul of the 1954 Code not to change the *Palmer* case rules. The Commissioner states that stock rights should be considered dividend income on the date issued, in the amount of their fair market value at that time. He also states that the rights would have a basis thereafter equal to such value, and that gain or loss on their subsequent sale would be measured by the difference between the sale price and such basis (Com. Br. 49). This could not be true in the case of corporate shareholders receiving rights, since section 301(b)(1)(B) expressly provides that the amount of the dividend in such case would be the lesser of the fair market value of the property received, or the basis of such property in the hands of the distributing corpora-

tion. Since a corporation issuing rights would never have a cost basis for such rights, the inevitable effect of the Commissioner's contention is that corporations exercising stock rights would never receive dividend income. Further, under the Commissioner's theory, shareholders allowing rights to lapse would have dividend income on receipt of the rights and a capital loss upon lapse.¹⁸

These tax effects, required by what Commissioner has termed "the technical analysis" (Com. Br. 49), may not be avoided by his suggestion that it may be "convenient" to ignore the results of his theory under the statutes and to treat the difference in time between the date of receipt and the date of sale as of no consequence. Congress has spelled out in detail in section 301 how dividends are to be taxed, and no vague, flexible rules may be improvised as a substitute for these statutory provisions.

The rule in the *Palmer* case has been well established for over 30 years, and has been so firmly entrenched in the administrative practice that not until these cases has the Commissioner contended that the *Palmer* rules governing the tax treatment of stock rights no longer apply under the 1954 Code.¹⁹ To change these rules, which have

¹⁸See Carlson, Taxation of "Taxable" Stock Rights: The Strange Persistence of *Palmer v. Commissioner*, 23 Tax L.Rev. 129, 142-143. In defense of the author, it must be conceded he refuses to apply his theories to stock rights issued as part of a reorganization, and cites an excellent discussion of the present cases approving the Second Circuit's decision (Note, 81 Harv.L.Rev. 482 (1967)); see Carlson, *op.cit.*, p. 149).

¹⁹G.C.M. 25063 (C.B. 1947-1, 45), which holds that stock warrants are not income when received by the shareholders under the 1939 Code, is to the same effect as the Commissioner's rulings to Pacific in these cases arising under the 1954 Code (A. 152-153, 158-159).

been so well understood by corporations and shareholders alike, and which are solidified by such a long period of established practice on the part of the Internal Revenue Service, would have wide ramifications (*American Automobile Assn. v. U. S.* (1961) 367 U.S. 687; *Commissioner v. Brown* (1965) 380 U.S. 563).

B. The Commissioner is in error in contending that Pacific did not "distribute [the Northwest stock] to a shareholder with respect to its stock."

The discussion on this aspect of the case focuses on the payment of cash by the Pacific shareholders in exercising their rights. Essentially, the Commissioner contends (1) that the transfer of the Northwest stock on such exercise was not a distribution but a sale; (2) that even if it was a distribution, it was not a distribution with respect to Pacific stock, but rather with respect to such stock and cash of \$16 for each Northwest share; and (3) that it was not a distribution to the Pacific shareholders, since "anyone" could buy rights and receive Northwest stock.

The bargain purchase regulations under section 301 are sufficient authority for rejection of the Commissioner's contention that a transfer of property by a corporation to its shareholders for a cash consideration is not a distribution. These regulations are to the effect that distributions to shareholders "with respect to their stock" under section 301 include transfers of corporate property to shareholders for less than fair market value "in a sale or exchange" (Income Tax Regs. sec. 1.301-1(j)) (cf. *Lester E. Dellinger* (1959) 32 T.C. 1178, and cases there cited). The Commissioner does take note of these

regulations in his brief (Com. Br. 33). However, he makes no attempt to explain the contradiction in his argument that Pacific's distribution of Northwest stock was not "with respect to its stock" under section 355, yet resulted in a taxable dividend under section 301. Section 301 is couched in the same terms: "distribution * * * made by a corporation to a shareholder with respect to its stock."²⁰ Moreover, as stated in the *Palmer* case, "a sale of corporate assets to stockholders is, in a literal sense, a distribution" (302 U.S. 69).

The other arguments of the Commissioner on these points are answered in taxpayers' opening brief at pages 52-57, inclusive. The Commissioner does not explain why he would impute to Congress an intent to exclude from section 355 distributions involving the *payment* of cash *by* the shareholders, when distributions with no payment are tax-free under that section. He does not rely on the attempted justification by the Ninth Circuit that "Congress could well conclude that the prospect that the same people * * * will continue to own the same business would be undermined if a distribution was effectuated by means of transferable stock rights, the exercise of which required substantial cash payments" (A. 325-326). The Commissioner does suggest, however, that "any" persons who were not Pacific shareholders could have bought rights and therefore received Northwest stock without regard to the stock of Pacific.

²⁰As stated in a recent Harvard Law Review note on these cases, the Commissioner's gloss on section 355 excluding distributions for consideration from distributions "with respect to stock" is untenable when applied to similar language in section 301(a) (81 Harv.L.Rev. (1968) 482, 485).

The short answer to both of these suggestions is that all of the rights were issued to the Pacific shareholders and over 95 per cent of Northwest stock was obtained through the exercise of rights by Pacific shareholders. Section 355 is cast in terms of what is actually accomplished, not in terms of what might have happened.

Section 355 is invoked by taxpayers not in respect of rights sold but of rights exercised. These rights were received by them as shareholders of Pacific. As shareholders of Pacific, they exercised these rights to retain their same proportionate interest in Pacific which they had before the Northwest stock was distributed. Necessarily, the rights which they received and exercised were with respect to their Pacific stock, for they were issued only to Pacific shareholders. Each share of Northwest stock was indivisible. Each Northwest share received by taxpayers in the exercise of their rights inured to and was derived from their ownership in Pacific stock, conditioned only on the payment of \$16 a share.

It makes no difference under section 355 whether the transfer of the Northwest stock and the payment of cash to Pacific are considered as two transactions or one. The Second Circuit indicated that the cash payment might be treated as a contribution of capital separately from the distribution of the Northwest stock (A. 285, 287). Whether it is so viewed, or whether it is viewed as the Tax Court did as a bargain purchase of the Northwest stock, the conclusion is in no way altered that the Northwest stock was distributed with respect to Pacific stock.

How Pacific is required to treat for its tax purposes the receipt of the cash in the exercise of rights by the

minority shareholders is beside the point. Pacific is not a party to these proceedings and certainly these taxpayers are not bound by the income tax treatment of Pacific in these transactions.

The difficulties in the computation of basis of the Pacific and Northwest stock alleged to result from the Second Circuit's analysis (Com. Br. 34) do not exist. On the contrary, the application of section 355 resolves basis difficulties encountered under the Commissioner's theory (Taxp. Br. 46, 47). For those Pacific shareholders who exercised their rights, the original cost basis of their Pacific stock and the amount paid in upon exercise of the rights must be allocated between their Pacific and Northwest stock in proportion to relative fair market value (Income Tax Regs. sec. 1.358-2(a)(2)). This accords with the realities of the situation. As for those who exercised purchased rights (Com. Br. 34, n. 11), it is clear that the cost of their Northwest shares is the amount paid for the rights plus \$16 a share, since they had no Pacific stock to which any cost basis can be allocated.

The Commissioner's contention that transferability of the rights defeats the requirement of a distribution to Pacific's "shareholders," on the ground that some might sell their rights and not receive the stock, is without merit. Congress considered the possibility of transfer of the distributed stock, and declared it insufficient to defeat the applicability of the statute in the absence of prearrangement (sec. 355(a)(1)(B)). As the Second Circuit stated (A. 288), the doctrine of continuity of interest has never been used to void a reorganization on the ground

that some of the shareholders might have sold some of their stock. The court pointed out that such a rule would void each and every attempted reorganization, for with rare exceptions, stock can always be sold. Here, continuity of interest manifestly was preserved (Income Tax Regs. sec. 1.355-2(c)). The required continuity is no more than 80 per cent. Obviously that requirement is satisfied when more than 95 per cent of the Northwest stock was distributed to the Pacific shareholders who exercised their rights.²¹

The argument of the Commissioner on pages 36 and 37 of his brief is difficult to follow. Nonrecognition treatment accorded spin-offs under section 355 lies, not in the fact that such transactions would be partial liquidations taxable at capital gain rates, but rather in the fact that they represent readjustments of corporate structures which effect adjustments of continuing interests in the same business enterprise under modified corporate forms (sec. 355(b)(1)(A); Income Tax Regs. sec. 1.355-2(c)). Even accepting the Commissioner's theory that "a genuine contraction of the business" is required by the application of section 355, it is manifestly present here. The businesses conducted by Pacific in the States of Oregon, Washington and Idaho were transferred to Northwest, and thereupon Pacific withdrew from those states and no longer conducted any business therein. To say that such withdrawal is not a contraction of Pacific's original business is scarcely credible.

²¹To the same effect are the comments of the Tax Court (A. 269, n. 10).

C. The distribution of the Northwest stock through two rights offerings satisfied the requirements of section 355(a)(1)(D).

The essence of the Commissioner's contention with respect to section 355(a)(1)(D) is:

"The language of Section 355(a)(1)(D) contemplates one and not two unconnected distributions of stock" (Com. Br. 41).

The Commissioner's distortions of the record in stating the facts relating to the two distributions of the Northwest stock are discussed ante, pp. 7-9. There is no warrant for the assertion that the 1963 offering was distinct and separate from the 1961 offering.

The Commissioner's one-distribution contention was raised for the first time in the courts of appeals. Both the Ninth Circuit and the Second Circuit rejected it. The Commissioner does not rely on the Ninth Circuit's holding that the 1963 offering was not part of the same transaction as the 1961 offering under the newly conceived test laid down by that court (A. 333). Instead, the Commissioner seeks to draw an inference from certain language of section 355 that only one distribution of stock is permitted under that section. Isolating such words and phrases as "immediately before" and "immediately after"²² and the term "distribution," he contends that

²²The Commissioner can find little comfort in this language in the light of similar language used in section 351, interpreted by Income Tax Regulations section 1.351-1(a)(1):

"The phrase 'immediately after the exchange' does not necessarily require simultaneous exchanges by two or more persons,

section 355(a)(1)(D) requires that the stock be disposed of "in a single transaction" (Com. Br. 42).

The "immediately before" and "immediately after" phrases have a perfectly reasonable and practical application in these cases. The requirement of control "immediately before" the distribution (sec. 355(a)(1)(A)) was satisfied by the admitted fact that Pacific owned all of the Northwest stock prior to its distribution. The reorganization was a single transaction which was accomplished through the two rights offerings in 1961 and 1963. The requirement that each of the corporations be engaged in the active conduct of trade or business "immediately after" the distribution (sec. 355(b)(1)) was satisfied by the continued conduct of the separated businesses by Pacific and Northwest respectively. The requirement of active conduct of the businesses "throughout the 5-year period ending on the date of the distribution" (sec. 355(b)(2)(B)) was satisfied by Pacific's continuous conduct of the business for many decades prior to the reorganization.

As the Second Circuit held, nothing on the face of the statute relates to the number of transactions or their timing which may be contained in a distribution (A. 291). More importantly, the result urged by the Commissioner, as pointed out by the Second Circuit, would be incongruous

but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure."

To like effect see Income Tax Regulations section 1.368-2(c), interpreting the phrase "immediately after the acquisition" in section 368(a)(1)(B) as permitting a series of acquisitions.

in the light of the nature of the transactions covered by section 355. A section 355 transaction which involves a transfer of assets to a new corporation controlled by the transferor, such as occurred here, qualifies literally as a reorganization under section 368(a)(1)(D). The Code does not require a single distribution for that or any other of the tax-free reorganizations defined in section 368. Such a requirement for divisive reorganizations under section 355 cannot be read into the Code without a substantial reason (A. 293).

The reasons advanced by the Commissioner have no support. He first suggests that when Congress intended that the tax consequences of a transaction be determined by examining events occurring in more than one year, it has said so explicitly. While this may be true in the instances cited (Com. Br. 42), it is not a universal rule. Where the tax consequences of a transaction depend on whether a reorganization has occurred, it is frequently necessary to examine events occurring in more than one taxable year. It is well settled in reorganization cases that steps not confined to a single taxable year, but which are integrated parts of a single plan, must be examined to determine whether or not all of the steps constitute a reorganization. This is a rule that has been invoked as much by the Commissioner to prevent tax avoidance as it has by taxpayers to obtain nonrecognition of gain (*Moffatt v. C.I.R.*, supra, 363 F.2d 262).

There is no merit in the Commissioner's suggestion that periodic distributions of Northwest stock could have been made as substitutes for dividend distributions. The speculation that Pacific could have distributed one tenth

of the Northwest stock in each of ten successive years is fully met by the Second Circuit's statement (A. 294):

"But that is not our case and it can scarcely be contested that the Code imposes a tax on facts, not expectations."

The record establishes that successive offerings of the Northwest stock as a substitute for dividends were not even possible under the plan. As must be conceded by the Commissioner, Pacific at no time retained any of the Northwest stock for any tax-avoidance purpose.

The 1961 and 1963 offerings were parts of the same transaction, as found by the Tax Court (A. 255, n. 4). Through these offerings, Pacific distributed all of the Northwest stock. Section 355(a)(1)(D) requires no more.

IV

THE SALE OF THE RIGHTS BY TAXPAYERS IN NO. 760 GAVE RISE TO CAPITAL GAIN AND NOT DIVIDEND INCOME.

The Commissioner's discussion of this issue develops a new theory of the tax treatment of stock rights. He rejects the rule of the *Palmer* case that the receipt of rights does not constitute income (Com. Br. 46-49). Instead the Commissioner contends that the *Palmer* rule is no longer applicable under the 1954 Code, and that under section 301, the Northwest rights must be treated as dividend income at their fair market value at the time of receipt (Com. Br. 49). The Commissioner then asserts that, while the technical analysis of the situation requires this result, "it is convenient" where rights are sold "to

minimize the amount of computation involved, and to treat the proceeds on sale as being the dividend, rather than the fair market value on the date of the receipt of the rights" (Com. Br. 49).²³ This cavalier approach has no support in the law. Congress has spelled out in section 301 how the amount of dividends is to be determined, and no rules to the contrary can be improvised as a substitute for the explicit statutory requirements.

The sale of the rights by taxpayers in No. 760 was an anticipatory realization on the Northwest stock that would have been received had the rights been exercised (*Helvering v. Horst* (1940) 311 U.S. 112). As the Second Circuit held, the nature of the distribution of Northwest stock, under section 355, was capital, and therefore the sale of the rights should give rise to a capital gain or loss (A. 296).

Regardless of whether the transaction qualifies under section 355, the rights sold by the taxpayers represented a portion of their equity and capital investment in Pacific which had been transferred to Northwest (Taxp. Br. 71-72). In disposing of the rights, they sold a portion of their equity, and this sale should be accorded capital gain treatment.

²³The Commissioner overlooks the provisions of section 301(b)(1)(B), requiring that corporate shareholders receiving a dividend in property are required to treat as the amount of the dividend the lesser of the fair market value of the property received or the basis of such property in the hands of the distributing corporation, ante, p. 7. Rights issued by a corporation could never have a cost basis in the hands of the issuing corporation. Under no circumstances could the Commissioner's theory be applied to corporate shareholders, for in all cases the measure of the dividend would be the zero basis rather than fair market value.

The taxpayers made an alternative contention in the courts below that the distribution of the Northwest stock should be treated as a distribution in partial liquidation of Pacific under section 346, in the event it was held section 355 did not apply. The Tax Court found it unnecessary to consider this alternative contention, and the Ninth Circuit, in reversing the Tax Court, remanded the case to permit its consideration. Under the taxpayers' alternative contention, even if it should be held that section 355 did not apply to exercise of the rights, the sale of the rights was a sale of the taxpayers' interest in a distribution in partial liquidation of Pacific under section 346, and a capital transaction, not under any circumstances an ordinary dividend taxable under section 301.

CONCLUSION

The judgment of the Court of Appeals for the Second Circuit in No. 760 should be affirmed, and the judgment of the Court of Appeals for the Ninth Circuit in No. 781 should be reversed with directions to affirm the Tax Court.

Respectfully submitted,

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